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Conference paper

KEY FINANCIAL AND NONFINANCIAL MEASURES FOR PERFORMANCE EVALUATION OF FOREIGN SUBSIDIARIES

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Abstract

Foreign subsidiaries, as organization units of a multinational company, are profoundly involved in the value creation process for and within the company. The performance evaluation of foreign subsidiaries is a crucial issue for globally-active companies not only in regard to value creation for the company but also in stimulating international expansion, as well as in steering resource allocation. Therefore, within each particular foreign subsidiary, the multinational company should implement a well-organized performance evaluation system which will serve as an integrative and cognitive mechanism for organizing business operations in the host country. The established performance evaluation system should assess the foreign subsidiary's performance within the particular local environment, as well as within the multinational company as a whole. Thus, the optimization of resource allocation is most effectively achieved by the multinational company. The effective performance evaluation system includes both financial and nonfinancial measures. The aim of this paper is to provide an understanding of both key financial and nonfinancial measures that multinational companies use for performance evaluation of their foreign subsidiaries. The methodology applied consists of qualitative research techniques, such as analysis, comparative analysis, and synthesis. On the basis of the results obtained, the contribution of this paper is reflected in the determination of relevant financial and nonfinancial performance measures that multinational companies should use in order to evaluate the real performance of their foreign subsidiaries.

Keywords: *balanced scorecard; financial measures; foreign subsidiaries; nonfinancial measures; performance evaluation;*

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Introduction

Performance evaluation of foreign subsidiaries is considered as a control tool which is used to evaluate the outputs of foreign subsidiaries in a certain period of time. This type of control tool, besides being a method of evaluating the degree of success of multinational companies in their process of internationalization, also determines the future subsidiary resource allocation (Ramsey, 2013).

The performance evaluation of companies is by itself a complex task and it is even more complex in international circumstances. The complexity increases greatly with overseas operations. Performance evaluation of foreign subsidiaries deals with certain complications, such as exchange rate fluctuations, effects of inflation in foreign countries, transfer pricing, the diversity between national and host cultures and many other issues related to environmental factors and variables in host countries. If the multinational company disregards these factors and variables, then it risks receiving inaccurate measures of foreign subsidiaries' operating results. Also, if standards of performance are set up inappropriately, then they stimulate foreign subsidiaries' managers to take actions contrary to corporate priorities. Consequently, a well-designed and organized performance evaluation system of a multinational company should allow headquarters managers 1) to ensure consistency between managerial behavior and strategic goals, 2) evaluation of profitability of foreign operations, 3) to detect areas that are not performing as planned, 4) efficient allocation of limited corporate resource, and 5) to evaluate managerial performance (Choi and Meek, 2011).

Multinational companies employ various measures in evaluating foreign subsidiaries' performance with the final purpose to understand the degree of company's success in achieving its strategic goal of internationalization. In international business literature, many authors advocate for a multidimensional approach to evaluating foreign subsidiaries' performance (Pangarkar, 2008).

This paper provides an analysis of financial and nonfinancial measures that multinational companies use in the evaluation of their foreign subsidiaries' performance. It also emphasizes the need for including nonfinancial measures in performance evaluation in order to obtain the real picture of foreign subsidiaries' operating results. The effective performance evaluation system should ensure the balance of financial and nonfinancial performance measures. The aim of the paper is to determinate the key financial and nonfinancial performance measures that multinational companies should use to evaluate the real performance of their foreign subsidiaries. In this context, the balanced scorecard approach of performance evaluation of foreign subsidiaries is also taken into consideration.

Consequently, the focus of this paper will be on three dilemmas which are given the most attention among researchers in this field of study:

1. What is the role of nonfinancial measures in performance evaluation of foreign subsidiaries?
2. What are the key financial and nonfinancial measures for performance evaluation of foreign subsidiaries?

3. Is the balanced scorecard a superior performance measurement tool for evaluation of foreign subsidiaries?

In light of the above, the methodology used consists of qualitative research techniques, such as analysis, comparative analysis, and synthesis.

Literature review

A search of literature showed that in the last twenty years there has been substantial interest in performance evaluation. The growing literature on this issue is focused on promoting performance evaluation. Also, it can be noted that performance evaluation has evolved from focusing on the financial perspective to the nonfinancial perspective (Taticchi et al, 2008).

In line with this, many authors have published research focusing on the need for balancing financial and nonfinancial performance measurements (Kaplan and Norton, 2001; Chapman, 2005; Collier, 2006; Merchant and Stede, 2007). The traditional focusing only on financial measures results in an incomplete picture of foreign subsidiaries' performance. Chapman (2005) has emphasized that the greatest shortcoming of financial measures is their focus on short-sighted solutions. Nonfinancial performance measures, on the other hand, are considered as more strategic in the long term.

Performance measures are considered as „quantitative tools that gauge a company's performance in relation to a specific goal or an expected outcome" (Needles et al, 2011, p. 735). Performance measures, both financial and nonfinancial, are used for different purposes including resources allocation, evaluation of foreign subsidiaries, incentive compensation, budgeting and planning, and setting targets. They are used to monitor and manage performance in many areas of the company including financial, internal process, employees, customer and suppliers (Whittington and Delaney, 2011).

From a theoretical perspective, the most appropriate evaluation measure of a particular foreign subsidiary is the comparison of business results obtained by the multinational company, including the subsidiary that is being evaluated, and business results of the multinational company without the subsidiary that is being evaluated. In other words, the optimal measure is its contribution to the goals of the multinational company. Since there are complex internal relations within the multinational company as a whole, it is almost impossible to make such comparison. Therefore, in order to evaluate the performance approximately to the previously stated measure, multinational companies use a combination of financial and nonfinancial performance measures (Zaman, 2004).

Traditional systems of performance evaluation were characterized by a predominant focus on financial evaluation measures. In the last two decades, highly competitive environments, in which multinational companies constantly deal, have contributed to the inclusion of nonfinancial performance measures. Reliance exclusively upon financial performance measures showed that it leads to short-termism. Consequently, nonfinancial performance measures have begun to be considered as an essential part of a performance evaluation system needed for the multinational company's long-term survival (Rathore, 2008).

Financial performance measures are expressed in monetary terms, such as revenue or profit, for instance. They can be found in financial statements such as balance sheets, income statements, and cash flow statements (Simons, 2000). When determining the type of financial measures that will be used for performance evaluation of foreign subsidiaries, it is very important to take into account the activities of a given subsidiary.

Since financial performance measures are mostly based on short-term measurement periods, it is considered that they motivate managers to become short-term oriented. For instance, when managers are relying on short-term measures there is a high possibility to reject positive NPV investments that may have an initial negative impact on the subsidiary performance measure but have high payoffs in later periods. Also, financial performance measures are „lagging measures", namely they determine the outcomes of managers' actions after a certain period of time. Consequently, it is very hard to establish a link between managers' actions and financial results reported (Dury and EL-Shishini, 2005). By implementing nonfinancial performance measures into a performance evaluation system, all the above-mentioned challenges are eliminated. In such a system, the achievement of short-term goals is no more a synonym of the performance evolution process.

Concern for long-range profitability has contributed for the companies to focus not only on figures in their budgets, but also on what hides behind such figures. That is enabled by nonfinancial performance measures. Nonfinancial performance measures are expressed in units other than dollars, such as productivity, customer satisfaction or quality failures (Collier, 2006). In other words, nonfinancial performance measures are used to evaluate quality or quantity of a business activity (Warren and Reeve, 2006). They can cover any aspect of running a business. To be effective, nonfinancial performance measures should be defined as precise objectives with exact definite times of completion (Dewan and Sudarshan, 2003).

Nonfinancial measures, unlike financial measures, are not based on information from company's financial statements. Analogically, nonfinancial measures, namely qualitative measures for performance evaluation, are characterized by greater subjectivity in regards to financial measures. Nonfinancial measures are mainly used when there are some specific factors and circumstances in the host country. The purpose of their use is to enhance the performance evaluation of foreign subsidiaries and their managers (Hedrik, 2008). However, Dury and El-Shishini (2005) have stated two significant problems that arise with the use of nonfinancial measures. Firstly, the problem of selecting the appropriate nonfinancial measures as key measures in evaluating foreign subsidiaries' performance. Secondly, evaluation process becomes more complex and confusing when some of the nonfinancial measures are in conflict with each other. It results in enhancing some measures at the expense of others.

To determine key financial and nonfinancial measures for performance evaluation of foreign subsidiaries, the results of the survey conducted by Harif et al. (2013) will be demonstrated. They did a tremendous work in studying and reviewing the performance measures that were covered in various empirical studies. They ended up identifying and determining the key financial and nonfinancial performance measures that can also be used in performance evaluation of foreign subsidiaries.

According to the results obtained, two financial performance measures can be considered as key financial measures in evaluating the performance of foreign subsidiaries. From Table 1., it can be noted that all five authors in their research have stated that profitability and cash flow position are appropriate for performance evaluation of companies (Chen and Shimerda, 1981; Matsumoto et al., 1995; Nelly, 2002; Luther et al., 2005; Sun and Li, 2006).

Table 1. Financial measures for foreign subsidiaries' performance evaluation

No.	Financial measures	A	B	C	D	E	Total	Selected from this study
1	Profitability	√	√	√	√	√	5	√
2	Cash flow position	√	√	√	√	√	5	√
3	Return on investment			√	√		2	√
4	Inventory turnover			√	√		2	√
5	Budget vs actual	√	√			√		√
	Total	3	3	4	4	3		5

Note: A= Nelly (2002); B= Luther et al. (2005); C= Chen and Shimerda (1981); D= Matsumoto et al. (1995); E= Sun and Li (2006)

Source: Adapted from Harif et al. (2013), p. 83.

In regard to nonfinancial measures, the obtained results have confirmed that customer satisfaction and product/service quality can be considered as key nonfinancial measures in evaluating the performance of foreign subsidiaries. From Table 2., it can be seen that four of the five authors in their research have listed that customer satisfaction is the measure used to evaluate companies' performance (Fitzgerald et al., 1991, Cima, 1993, Haskett et al., 1994, Zaman, 2004). At the same time, product/services quality is considered as the appropriate nonfinancial measure for companies' performance evaluation by all five authors (Fitzgerald et al., 1991; Cima, 1993; Haskett et al., 1994; Zaman, 2004; Cho and Pucik, 2005).

The need for determining key performance measures that link measurements to company's strategy led to the emergence of the balanced scorecard. The balanced scorecard involves two types of performance measures. The first includes lagging measures. These are the financial measures from the financial perspective and they are the results of past actions. The second type of performance measures are leading measures that are considered as drivers of future financial performance. These are the nonfinancial measures relating to the customer, internal business process and learning and growth perspectives (Dury and El-Shishini, 2005).
The balanced scorecard approach of foreign subsidiaries' performance evaluation is discussed in the following section.

Table 2. Non-financial measures for foreign subsidiaries' performance evaluation

No.	Nonfinancial measures	A	B	C	D	E	Total	Selected from this study
1	Customer satisfaction	√	√	√	√		4	√
2	Product/service quality	√	√	√	√	√	5	√
3	Market share					√	1	√
4	Employee efficiently	√	√				2	√
	Total	3	3	2	2	2		4

Note: A=Zaman (2004); B=CIMA (1993); C=Fitzgerald et al. (1991); D=Haskett et al. (1994); E=Cho and Pucik (2005)

Source: Adapted from Harif et al. (2013), p. 83

Balanced scorecard approach of performance evaluation of foreign subsidiaries

There is a number of various types of performance evaluation systems and frameworks used in companies. In the 1990s, the most known performance measurement frameworks were the balanced scorecard and value-based management. Companies around the world have adopted one or both performance measurement frameworks into their performance measurement systems (Whittington and Delaney, 2011).

Balanced Scorecard, developed by Robert Kaplan and David Norton (1992), is one of the most well-known models for balancing financial and nonfinancial performance measurements. This model is considered as a performance measurement framework that added nonfinancial performance measures to the traditional financial performance measures in order to provide a more holistic view of the real performance achieved.

The balanced scorecard is a performance measurement framework that enables companies to set, track and achieve their key business strategies and objectives. After business strategies are established, they are deployed and tracked through the four perspectives of the balanced scorecard. These perspectives are necessary for managers to be able to plan, implement and achieve their business strategies and objectives. The four perspectives of the balanced scorecard are (Asefeso. 2013; Whittington, 2014):

1. *Financial perspective:* This perspective focuses on tracking financial requirements and performance. Example performance measures include return on invested capital, profitability, and revenue growth;
2. *Customer perspective:* This perspective focuses on measuring customers' satisfaction and their performance requirements. Example performance measures include customer retention and customer satisfaction;
3. *Internal business process perspective:* This perspective focuses on measuring the critical-to-critical process requirements and measures. Example performance measures include cycle time and number of defects;

4. *Learning and growth perspective:* This perspective focuses on how a particular company educates its employees, how it gains and captures its knowledge and how the company uses it to maintain its competitive edge. Example performance measures include hours of training per employee, employee satisfaction and information technology expenditures per employee.

Analogically, Duru and El-Shishini (2005) have stated that foreign subsidiary performance should be evaluated within a balanced scorecard context, taking into account both financial and nonfinancial measures. According to them, there is not any guidance as to how financial and nonfinancial measures should be integrated and balanced within the balanced scorecard in order to evaluate foreign subsidiary performance. It is primarily a subjective assessment of senior corporate management.

Consequently, the balanced scorecard enables companies to evaluate themselves accurately and place themselves in a better position in competition with others (Kairu et al, 2013). Malgwi and Dahiru (2014) have emphasized that using the balanced scorecard as a performance measurement tool can contribute to multinational companies to achieve their overall performance and make profit. They have recommended the balanced scorecard framework as a performance measurement tool because it incorporates both financial and nonfinancial performance measures and evaluates companies holistically.

The result of the balanced scorecard application leads to sustainable business growth in line with the strategy defined by top management. Because this is a very complex method of strategic management, it is most prevalent among large multinational companies that can afford it financially and carry it out completely (Kaplan and Norton, cited in Hornungova, 2014).

Besides its popularity, literature points out many shortcomings of the balanced scorecard, such as its static nature, lack of stakeholder focus, lack of cause-effect relationships, a closed system approach, etc. (Ahn, 2001; Akkermans and Oorschot, 2005). Neely and Bourne (2000, p. 3) have demonstrated that „70 percent of a balanced scorecard implementation fails due to its inappropriate design and implementation failure". Consequently, most recent works, with an emphasis from 2001 to 2011, focus on overcoming the evident shortcomings of the balanced scorecard. Although the way performance is evaluated has been drastically changed, the balanced scorecard is still one of the most popular and prevalent performance measurement frameworks.

In line with this, Yadav and Sugar (2013) have classified all performance measurement frameworks designed in the last two decades into five categories: 1) classical and dominant performance measurement models, 2) holistic and integrated performance measurement models, 3) frameworks updating the balanced scorecard approach, 4) context specifics performance measurement models and 5) recently developed performance measurement models. Each of these frameworks has strengths and weaknesses, and room for further improvements. The main characteristic of recent frameworks is focusing on a more balanced approach. The last group of models, known as recently developed performance measurement models, involves performance methods developed in the last seven years. The topics included are referred to as sustainability and flexible strategy game-cards. These models analyze performance from the perspective of both the company and the costumer.

Conclusion

Performance evaluation of companies is by itself a complex task and it is even more complex in international circumstances. The complexity increases greatly with overseas operations. Performance evaluation of foreign subsidiaries deals with certain complications, such as exchange rate fluctuations, effects of inflation in foreign countries, transfer pricing, the diversity between national and host cultures and many other issues related to environmental factors and variables in host countries. Consequently, multinational companies employ various measures in evaluating their foreign subsidiaries' performance with the final purpose to understand the degree of company's success in achieving its strategic goals of internationalization. In international business literature, many authors advocate for a multidimensional approach to evaluating foreign subsidiaries' performance.

The paper has focused on three research questions: 1) What is the role of nonfinancial measures in performance evaluation of foreign subsidiaries?; 2) What are the key financial and nonfinancial measures for performance evaluation of foreign subsidiaries? and 3) Is the balanced scorecard a superior performance measurement tool for evaluation of foreign subsidiaries?.

Based on a comprehensive analysis of previous empirical studies and research from the target area, certain conclusions have been reached on the basis of the research questions set.

In regard to the first research question, it can be concluded that nonfinancial performance measures are significant in performance evaluation of foreign subsidiaries. By implementing nonfinancial performance measures into a performance evaluation system all limitations related to financial performance measures are eliminated. In such a system, the achievement of short-term goals is no more a synonym of the performance evolution process. Nonfinancial measures, unlike financial measures, are not based on information from company's financial statements. Analogically, Hedrik (2008) has claimed that nonfinancial measures are mainly used when there are some specific factors and circumstances in the host country. The purpose of their use is to enhance the performance evaluation of foreign subsidiaries and their managers.

In regard to the second research question, the key financial and nonfinancial measures for performance evaluation of foreign subsidiaries were determined. According to the results obtained in the survey conducted by Harif et al. (2013), two financial performance measures can be considered as key financial measures in evaluating the performance of foreign subsidiaries, namely profitability and cash flow position. At the same time, customer satisfaction and product/service quality are considered as key nonfinancial performance measures.

Finally, in regard to the third research question, Duru and El-Shishini (2005) have stated that foreign subsidiary performance should be evaluated within a balanced scorecard context, taking into account both financial and nonfinancial measures. According to them, there is not any guidance as to how the financial and nonfinancial measures should be integrated and balanced within the balanced scorecard to evaluate foreign subsidiary performance. It is primarily a subjective assessment of senior corporate management. The balanced scorecard is still the most popular and prevalent performance measurement framework because besides its evident shortcomings, it incorporates both financial and nonfinancial performance measures and evaluates the performance of multinational companies holistically.

Recommendations for future research are referred to the idea of determining the extent to which the balanced scorecard is used only as a tool for implementing the company's strategy and the extent to which it is used as a performance evaluation tool. In accordance with this, future research is also required to determine how financial and nonfinancial performance measures are integrated to evaluate foreign subsidiary performance in the most comprehensive way.

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